No. 6763.

IN THE

United States
Circuit Court of Appeals,

FOR THE NINTH CIRCUIT.

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Merchants Trust Company, Trustee of Trust No. 123-B N. S.,
Appellant,

vs.

Galen H. Welch, Collector of Internal Revenue for the Sixth Collection District of California,
Appellee.

BRIEF ON BEHALF OF APPELLANT.

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TABLE OF CASES AND AUTHORITIES CITED.

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STATEMENT OF THE CASE.

This is an appeal from a judgment, for defendant, of the United States District Court, in and for the Southern District of California, Central Division, Honorable George Cosgrave, judge, denying appellant a refund of 1928 income taxes in the amount of $5,712.65 paid at corporate rates.

The Commissioner of Internal Revenue held that this trust, which is ordinarily known as a "real estate subdivision trust," was an "association" taxable as a corpo-

ration, and assessed a tax against the Trustee which paid it to the defendant under protest.

All questions have been disposed of either by the complaint and answer, or by stipulation, except the one stated below:

THE QUESTION INVOLVED.

The sole issue involved is whether appellant was, during the taxable year 1928, an association taxable as a corporation under section 701(a) (2) of the Revenue Act of 1928. If it was not taxable as an association there was no tax due from it as an entity and the entire amount paid, together with interest, is refundable.

This results from the fact that the Commissioner of Internal Revenue collected this tax on the theory that the income realized by the Trustee herein involved was taxable as that of an association, whereas under the Revenue Act of 1928, no tax is imposed upon a joint adventure as an entity, nor upon a partnership as an entity, nor upon a trust the income of which is distributable to the beneficiaries or members. In those situations, the beneficiaries or members of the trust, partnership or joint adventure, as the case may be, include their share of the income of the association in their individual return (whether the income was actually distributed to them or not), and pay the tax thereon at the prevailing normal and surtax rates applicable to individuals. The individuals involved in this case have reported their dis-

tributive share of the income of appellant in their returns and paid the tax thereon.

A corporation (defined as including an association), on the other hand, pays a flat tax rate as an entity on its net income regardless of the amount. Its shareholders are treated as separate entities from the corporation and include, in their returns, only dividends actually paid to them in the year the dividends are paid, being liable on such dividends only for surtax rates with no normal tax.

The corporate tax rate, during 1928, was 12 per centum. Normal tax rates on individuals during 1928 were 1½, 3, and 5 per centum, depending on the amount of the income, and an additional surtax at rates graduated from 1 to 20 per centum. To tax this enterprise as a corporation therefore imposes, ultimately, an additional burden on each beneficiary of the difference between his normal tax and 12 per centum, which difference will vary from 10½ to 7 per centum on his share of the income of the trust or joint venture.

Even if it should be held that this enterprise is not to be treated as a joint adventure, appellant contends that it would nevertheless be wrong to tax it as an association, because if it is not to be treated as a joint adventure, the income should be taxed as that of "property held in trust" under section 162(b) of the tax law. It is to be treated for tax purposes either as a joint adventure—which we believe to be the correct treatment—or as a trust.

STATUTES INVOLVED.

The income of a joint adventure is treated as the direct income of the individual members and taxed under sections 11 and 12(a) of the Revenue Act of 1928, the taxing words of which are as follows:

> "11. There shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax equal to the sum of the following: * * *"
>
> "12(a). There shall be levied, collected, and paid for each taxable year upon the net income of every individual a surtax as follows: * * *"

A joint adventure is a partnership limited to a specific venture. Partnerships are not taxable under section 181 of the Revenue Act of 1928, which reads:

> "Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity."

The income of a corporation is taxed to the corporation as an entity under section 13(a) of the Revenue Act of 1928, of which the taxing words are:

> "There shall be levied, collected, and paid for each taxable year upon the net income of every corporation, a tax of 12 per centum of the amount of the net income in excess of the credits against net income provided in Section 26."

Section 701(a)(2), of the same Act, provides as follows:

> "The term 'corporation' includes associations, joint-stock companies, and insurance companies."

The following provisions as to the taxation of the income of trusts are contained in section 162(b):

> "The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that * * * (b) There shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the beneficiaries, * * * but the amount so allowed as a deduction shall be included in computing the net income of the beneficiaries whether distributed to them or not. * * *"

The Civil Code of California, section 857, relative to the creation of trusts, in effect throughout 1928, provided as follows:

> "Express trusts may be created for any of the following purposes:
>
> "(5) To convey, partition, divide, distribute, or allot real property in accordance with the instrument creating the trust, subject to the limitations of the same title."

STATEMENT OF THE CASE.

In this case one C. C. C. Tatum had contracted to buy a number of lots, comprising 136½ acres, in a tract on which subdivision had begun. The property was held by the Hellman Commercial Trust & Savings Bank in a subdivision trust. Not desiring to assume the entire deal, Mr. Tatum transferred the purchase contract to the Merchants Trust Company and interested nineteen other persons to participate with him in paying for and reselling the lots. [R. 121.]

The Merchants Trust Company entered into a formal contract to purchase the land, on behalf of certain persons called "Buyers," from the Hellman Commercial Trust &

Savings Bank. The Merchants Trust Company had no interest of its own in the contract, and merely held it for the persons involved in the adventure. [R. 52.]

The sole object of the enterprise was to complete the subdivision of the tract, make such improvements as were necessary to effect sales, and sell the lots at a profit. [R. 50 to 74.]

The entire plan of procedure was specifically set out in the Declaration of Trust. The sales agent was named; the sales terms and the prices were specified, and the manner in which the receipts were to be distributed was specifically set forth. The Declaration of Trust provided that the entire receipts from the sales of the lots should be distributed first to pay the interests who had contracted to sell the real estate to Tatum, and then, after the payment of expenses, the balance was to be distributed to the members of the adventure. The capital was, therefore, to be immediately returned and not reserved for additional purchases of land, or further adventures. [R. 50 to 70.]

The trust indenture provided a minimum sales price for each of the lots. · [R. 55, 56 and 57.]

The trust indenture provided that after full payment of the purchase price had been made by the Buyers to the Seller, all restraints imposed on the Buyers shall be removed and the proceeds of the sale shall be applied as directed by the Buyers, subject to the Trustee's fees and advances. [R. 62.]

The trust indenture provided that the Trustee should follow the wishes of the majority in beneficial interest, and that each of the Buyers appointed C. C. C. Tatum as

his attorney in fact, subject to the termination of such authority as attorney in fact in a specified manner. [R. 63-64.]

C. C. C. Tatum was appointed by the trust indenture as manager and exclusive selling agent for a term of three years, and was to receive as compensation, a commission of 20 per centum on sales. [R. 68-69.]

The Buyers or beneficiaries agreed to pay for all costs of street work and other improvements [R. 58-59]; taxes and assessments [R. 59-60]; and other expenses. [R. 64.]

Corporate trustees have been used in real estate subdivision work in Los Angeles for over 25 years. The purpose of the trust was three-fold:

> (a) To secure to the seller of the land payment of any unpaid balance due.
>
> (b) To secure to the lot purchaser a merchantable title when the payments provided for by his contract had been made.
>
> (c) To secure to any person who loaned money for improvements, or otherwise, repayment of amounts so loaned. [R. 38 to 40.]

Individual subdivision without the use of a responsible trust company resulted in grave abuses in that the lot purchaser often lost his money in cases where blanket mortgages were foreclosed, because of the failure to provide for proper mortgage releases and the proper distribution of funds collected. [R. 38.]

The trust had no name, except the number given it by the Trustee upon its own records. It did not have its own office or place of business. It had no officers, stationery, seal, or by-laws. [R. 35-36.]

The beneficiaries never had a formal meeting at which they voted on any question pertaining to the business of the trust, or gave instructions to Mr. Tatum or the Trustee. [R. 35.]

The beneficiaries never changed their attorney in fact or the Trustee. [R. 35.]

The Trustee never acquired more than the original lots specified in the Declaration of Trust. [R. 35.]

In 1928, no improvements were made; no maps were recorded; and no streets were dedicated. [R. 36.]

During the year 1928, the activities of the trust were devoted substantially to the collection of the amounts due on sales made in prior years. Three lots only were sold in 1928. [R. 115-116.]

From the inception of the trust to December 31, 1928, and subsequent thereto, the books and records of the trust were kept on the basis of actual cash receipts and disbursements. [R. 33.]

During the years 1923, 1924, 1925, 1926 and 1927, the Trustee, on behalf of the trust, filed returns with the Collector of Internal Revenue for the Sixth Collection District of California, on Form 1041, as a trust, under the provisions of section 219 of the Revenue Acts of 1921, 1924 and 1926. [R. 33.]

For the years 1923 to 1927, inclusive, the trust was taxed as a trust by the Commissioner of Internal Revenue, under the provisions of section 704(b) of the Revenue Act of 1928. [R. 33.]

The minimum restrictions to be imposed on the Buyers of lots sold by this trust were fixed by the Seller of the

land, namely, Hellman Commercial Trust & Savings Bank. [R. 35.]

The Trustee required any and all instructions from Mr. Tatum to be given in writing. Mr. Tatum conferred with and received the approval of the Trustee before making expenditures for improvements, and conferred with and received the approval of Mr. Cotton (the beneficiary of the Hellman Commercial Trust & Savings Bank trust which sold the land to appellant), relative to increasing the minimum building restrictions imposed on the lot purchasers. [R. 36.]

Some of the beneficiaries, upon request, received information from the Trustee or the sales agent, relative to the development and sale of the trust property. [R. 36-37.]

Some of the beneficial certificates were sold, transferred and assigned. [R. 37.]

Ninety-two per centum of the lots were sold prior to 1928, during the time that the trust was taxed as a pure trust. [R. 108 to 116.] The capital of the trust had been returned to the beneficiaries before January 1, 1928. [R. 148-149.]

Errors Relied Upon.

The appellant submits that the District Court erred in holding that the trust was an association within the meaning of section 701(a)(2) of the Revenue Act of 1928.

ARGUMENT.

The "Buyers" were joint adventurers and the income of their joint adventure (Trust 123-B N. S.) was taxable directly to them in accordance with their distributive shares.

The difference between a joint adventure on the one hand, and a partnership or an association on the other

hand, is that the joint adventure is a combination of persons jointly interested in a specific or single undertaking, whereas a partnership or association is a combination of persons jointly interested in a permanent undertaking of a particular kind or character.

The law provides that partners shall be taxed only in their individual capacity, section 182 of the Revenue Act of 1928, while associations are taxed as entities at corporate rates. (Section 701(a)(2) of the Revenue Act of 1928.)

The Commissioner of Internal Revenue, the Board of Tax Appeals, and the courts, have uniformly held that a joint adventure, while not specifically mentioned as one of the classes of taxpayers in the acts, is in fact a partnership.

The Revenue Bill of 1932 recognizes the administrative and judicial rulings on this point and in section 1004(a)(3) defines a partnership as follows:

> "The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this Act, a trust or estate or a corporation; and the term 'partner' includes a member in such a syndicate, group, pool, joint venture, or organization."

The administrative practice, as recognized by the Revenue Bill of 1932 and the decisions of the various tribunals, shows that enterprises or combinations which constitute joint adventures for ordinary purposes, are also joint adventures for the purpose of the Revenue Act.

The same thing is true with respect to trusts. The Revenue Act provides a specific method for taxing income of trusts. (Section 162(b) of the Revenue Act of 1928.) Appellant is a pure trust in form and by the law of California. (See Civil Code 857.)

Both the common law and the Revenue Acts recognize associations. Under the common law and by many decisions of the taxing tribunals, appellant is not an association, but a trust or joint adventure.

The Commissioner of Internal Revenue, however, has not taxed appellant as a trust, which it plainly is, or as a joint adventure, which it is according to the common law decisions on joint real estate adventures limited to specified properties, but has taxed appellant under an entirely different section of the law which does not clearly apply.

The principle is fixed that if a reasonable doubt exists as to whether or not an object has been clearly pointed out as being a subject of taxation by a taxing statute, that it must be exempt; or, in other words, taxing statutes must be strictly construed in favor of the taxpayer and against the Goverment.

There is a great doubt as to whether a liquidating, self-executing, single venture trust or joint adventure, such as appellant, is so like a permanent, continuous, progressive corporation that it should be taxed as such.

The District Court held appellant to be an association taxable as a corporation under the authority of a decision of this Honorable Court in the case of *Trust No. 5833, Security-First National Bank of Los Angeles, Successor*

to Security Trust & Savings Bank, Trustee v. Welch, 54 Fed. (2d) 323.

This court, in that case, held a real estate subdivision trust to be an association taxable as a corporation. The trust in that case had a board of five (5) syndicate managers, however, who were given authority to manage the affairs of the trust.

A Petition for Writ of Certiorari to the Supreme Court of the United States has been filed in that case, and the matter is now pending in the Supreme Court. The petition has not, as yet, been acted upon.

In any event the decision in *Trust No. 5833 v. Welch* is not binding on appellant. In the case at bar there was an existing subdivision trust of which the Hellman Commercial Trust & Savings Bank was Trustee. Appellant was organized to take over and liquidate a portion of the property held in the Hellman trust. The purpose of Trust 123-B N. S., therefore, was to liquidate a portion of a subdivision trust, while the purpose of Trust No. 5833 was to create a subdivision trust.

In the case at bar there is nothing akin to a board of directors, such as the board of directors present in Trust No. 5833. Virtually, every step from the purchase of the lots, through the improvements, sale of the property, and the distribution of the proceeds, was specifically set out in Trust 123-B N. S. The restrictions as to the type of improvements to be put upon the property was a matter within the control of the Seller, the Hellman Commercial Trust & Savings Bank. The terms, the minimum sales prices of the lots, were fixed by the trust indenture. The commission to be paid the sales agent, the name of

the sales agent, the type of improvements, the exact method of distribution of proceeds were all specifically set forth in the trust indenture. The adventure was limited to the original lots, upon the sale of which the proceeds were required to be distributed. Any problems remaining, after all these specific provisions and instructions, were to be solved by the beneficiaries who appointed Mr. Tatum as their agent to exercise their restricted powers.

While a board of five (5) syndicate managers resembles a board of directors of a corporation, a single agent does not resemble a board of directors of a corporation, but resembles a partner or joint adventurer, or trustee, or agent of tenants in common, who acts for his associates.

Since the decision of this court in the case of *Trust No. 5833 v. Welch, supra,* the United States Circuit Court of Appeals for the Seventh Circuit decided the case of *Russell Tyson, et al., Trustees of the Zenith Real Estate Trust v. Commissioner,* 54 Fed. (2d) 29. In that case the court held that the trust was taxable as a trust and not as an association where several trustees held a parcel of real property which was subject to a long term lease. The property was sold to a tenant in the taxable year involved.

This court, in its decision in *Trust No. 5833 v. Welch, supra,* referred to the Board of Tax Appeals' decision in the case of *Sloan v. Commissioner,* 24 B. T. A. 61. In that case an appeal to this court has been filed, No. 6808.

The entire question, therefore, of real estate subdivision trusts is still open and appellant submits that

it is a joint adventure, the income of which is taxable but once to its members, and not a separate entity, the income of which is taxed twice: Once to the association as an entity, and again to the beneficiaries on the dividends.

This court has so recently decided several cases involving this subject that it seems unnecessary for appellant to make extended argument, or cite the many cases in its favor, with all of which the court is familiar.

CONCLUSION.

It is therefore respectfully submitted that the decision of the District Court should be reversed.

Dated: April 14, 1932.

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